

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**A REVIEW OF SELECTED AREAS OF THE CHINO
UNIFIED SCHOOL DISTRICT'S BUILDING PROGRAM**

**A Review of Selected Areas of the Chino
Unified School District's Building Program**

P-142, July 1992

**Office of the Auditor General
California**



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July 2, 1992

P-142

Honorable Robert J. Campbell, Chairman
Members, Joint Legislative Audit Committee
State Capitol, Room 2163
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning a review of selected areas of the Chino Unified School District's building program. The report indicates that the Chino Unified School District (district), to ensure that it protects its best interests, needs to include language in its future contracts that specifically and clearly identifies the services the contractors will provide, the fees the contractor will be paid for those services, and the time frames within which the contractor will provide the services. Furthermore, the district, to ensure that it implements the recommendations of its independent auditor, should fill a vacant position as soon as possible.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kurt R. Sjoberg".
KURT R. SJOBERG
Auditor General (acting)

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Summary

Results in Brief

The Chino Unified School District (district) needs to improve some aspects of its building program. The district's building program includes a land bank program and a cash management program and is financed principally with funds raised through the issuance of certificates of participation (a bond-like debt instrument) and revenues collected through a special tax and a developer fee. During our audit, we noted the following concerns:

- Some of the district's contracts for financial services associated with the building program do not contain specific and clear language pertaining to some services, time requirements for some services, or payments due to the contractor; and
- The district has not fully implemented all the recommendations of its independent auditor's 1990 and 1991 audit reports on the district's building program.

Background

The district is governed by a five-member board of education and comprises the city of Chino, the city of Chino Hills, the southern portion of the city of Ontario, and certain unincorporated areas of San Bernardino County. It covers an area of 88 square miles and operates 16 elementary schools, 4 junior high schools, 3 high schools, 2 fundamental schools, and a continuation high school. Current enrollment in the district's schools is approximately 24,800 students, with approximately 1,000 full-time and part-time teachers and other educators and approximately 940 classified employees. In fiscal year 1990-91, the district had budgeted expenditures of approximately \$88.9 million.

**Some Contracts
Need More
Specific
Language**

The district's contracts should contain language that is sufficiently specific and clear to protect its best interests. Specifically, the district's contracts should contain a clear and complete statement of the services to be provided, the time requirements for performance and completion of the contract, and the basis upon which payments are to be made.

In our review of the district's three contracts with its financial advisor, we noted that two of the contracts did not clearly identify the fees to be paid to the financial advisor. Further, these two contracts required the financial advisor to assist the district in several functions without defining the degree or type of assistance to be provided. Lastly, the two contracts called for the financial advisor to prepare certain reports on a periodic basis with no further definition of the timing and frequency of the reports.

The contracts did not always contain clear and specific language because the district has no contracting procedures manual that sets standards for contract terms and language. The district superintendent stated that the district has had no disputes with the financial advisor over services or fees. Nonetheless, because these two contracts did not contain clear and specific language, we could not verify that the fees the district paid to the financial advisor were appropriate, that the district received the services it expected to receive from the financial advisor, or that the district received the reports from the financial advisor at the times it required them. Furthermore, contracts with the type of problems we have identified may fail to protect the district's best interests under certain circumstances. For example, as a result of inaccurate statements of the basis of fees, the district may be unable to determine the proper fees due for contracted services, and it may pay more than it expected to pay for those services. It also may not receive the services it expected to receive under a contract, and it may not receive contracted services when it expects or requires them.

**All Audit
Recommen-
dations
Not Fully
Implemented**

Although the district agreed to implement the recommendations contained in reports issued by an independent auditor in 1990 and 1991 concerning the district's building program, the district has not fully implemented all the recommendations. For example, the district has not regularly reconciled status reports of the building program with certain monthly statements and has not consistently tracked cash transfers between its cash management fund and its certificates.

The district has not fully implemented the auditor's recommendations because, according to the administrative director of business services, it has not yet filled the vacant position of accounting technician. The district's failure to implement the independent auditor's recommendations fully may reduce its level of control over the district's financial assets or may result in essential information about the district's building program being unavailable to the district's board of education.

**No Weaknesses
in Other Areas
of the District's
Management of
Its Building
Program**

We found no weaknesses in several areas of the district's management of its building program. We reviewed the district's ability to make the lease payments required by two of the district's certificates. Although the district was aware that some sources of anticipated revenues may not be available when the lease payments must start, it identified alternative revenue sources, such as general obligation bonds, with which it could make the lease payments. In addition, we reviewed the procedures that the district followed in acquiring parcels of land through its land bank program and found them to be reasonable.

We also reviewed the earnings of the district's cash management program in fiscal year 1990-91 to determine whether the district made a reasonable and prudent decision to invest its funds in the program. Our review indicated that the district earned approximately \$640,000 more than it would have earned had it invested the funds in the San Bernardino County School District Investment Fund. Our review also showed that the district, when required, complied with federal requirements to calculate arbitrage rebate for the 1987 certificates.

**Allegations of
Conflicts of
Interest**

We received allegations that conflicts of interest may have occurred at the district because, in 1989, one member of the district's board of education sold some of the district's certificates to another member of the board of education and because, during 1990, an employee of the district was also employed by a contractor for the district. After conducting an extensive review, we cannot conclude that these situations violated state laws concerning conflicts of interest involving local public officials.

**Recommen-
dations**

To ensure that it protects its best interests, the district should include language in its future contracts that specifically and clearly identifies the services to be provided, the fees to be paid for those services, and the time frames within which those services will be provided. To ensure that this language is included in its future contracts, the district should develop and follow a contracting manual that requires that each of those areas identified be specifically and clearly addressed in all district contracts.

To ensure that it implements the independent auditor's recommendations, the district should make a permanent assignment to its vacant accounting technician position as soon as possible.

**Agency
Comments**

In its response to our report, the district agreed with our two recommendations. Concerning our first recommendation, the district superintendent stated that the recommendation was sound and that information from the district's legal counsel and from the State Administrative Manual will assure that future contracts protect the best interests of the district. Concerning our second recommendation, the district superintendent stated that the vacant accounting technician position was filled as of April 1992.

Introduction

The Chino Unified School District (district) is governed by a five-member board of education (school board) and comprises the city of Chino, the city of Chino Hills, the southern portion of the city of Ontario, and certain unincorporated areas of San Bernardino County. It covers an area of 88 square miles. The district operates 16 elementary schools, 4 junior high schools, 3 high schools, 2 fundamental schools, and a continuation high school. Current enrollment in the district's schools is approximately 24,800 students, with approximately 1,000 full-time and part-time teachers and other educators as well as approximately 940 classified employees. In fiscal year 1990-91, the district had budgeted expenditures of approximately \$88.9 million.

From fiscal year 1990-91 through fiscal year 2000-01, the district expects an increase in student enrollment of approximately 57 percent. To accommodate this projected increase in enrollment, the district started a building program, which includes the acquisition, construction, and installation of a number of school facilities. The district's building program also includes a land acquisition program (land bank) designed to ensure the availability of future school sites in appropriate locations and to avoid expected future appreciation in land costs. The district has financed the building program principally through lease financing, including the issuance of certificates of participation. Additionally, the district has a cash management program in which it invests special tax and developer fee revenues.

Lease Financing Debt financing for school districts is the incurring of obligations payable over time, the proceeds of which are used for school district purposes. School districts can use debt financing as a means of obtaining the funds necessary to acquire land, build school facilities and other improvements, and obtain equipment.

School districts can use a variety of debt-financing techniques. One available technique is long-term lease financing. Through lease financing, school districts can lease property or equipment, and investors, through any of several mechanisms, can receive the lease payments from the district.

District Lease Financing

Since 1986, the district has used lease financing at least five times to obtain funds for acquiring land, building school facilities, and obtaining equipment. The district has also used several different mechanisms for making lease payments to investors. For example, in 1989, the district entered a direct lease with a corporation to finance the acquisition of facilities and equipment. Under a direct lease, a school district simply leases property from a company or bank and then makes lease payments directly to the company or bank.

In 1986, 1988, and 1989, the district used a different mechanism to make lease payments to lessors, issuing certificates of participation. Through this mechanism, a school district leases property from a nonprofit corporation, joint powers agency, or other third party. These certificates, which are sold to investors much as bonds are, represent the investors' undivided interests in the lease payments the school district is to make pursuant to the lease. In other words, each investor is entitled to a proportionate amount of the lease payments to be made by the district. The school district uses the proceeds from the sale of the certificates of participation to pay the costs of acquiring land, building school facilities, or obtaining equipment. The interest investors earn from the certificates of participation is generally exempt from federal income taxes.

In 1987, the district used a variation of a certificate of participation, issuing a purchaser certificate to obtain relocatable classrooms and equipment. Under a purchaser certificate, rather than selling certificates to multiple investors, the district sold a single certificate to a single investor.

The typical issuance of purchaser certificates and certificates of participation involves a number of parties, including a school district as lessee, a nonprofit corporation or other third party as lessor, and a trustee or fiscal agent representing the investor or investors that buy these certificates.

In a typical issuance of purchaser certificates and certificates of participation, the school district first identifies the property it wishes to acquire or the facility to be constructed and equipped. It then enters into a lease with the lessor for use of the property or facility. The sale of these types of certificates provides the funds for the lessor to acquire the property. The school district then undertakes the construction of the facility, and the lessor leases the improved site to the school district under the terms of the lease. Because the buyers of the purchaser certificates and certificates of participation provide funds to acquire and improve the site, they receive the lease payments from the school district through the trustee once the school district begins making those payments. Although this financing mechanism is complex, the school district, simply stated, has promised to make lease payments to a trustee (as a representative of the certificate buyer or buyers) in exchange for the funds raised through the sale of the certificates.

In 1989, the district participated in issuing \$30.0 million in certificates of participation to purchase parcels of land at their present day costs. The district believed that these parcels were necessary to meet future growth in student enrollment. The program was referred to as the land acquisition program.

Land Acquisition Program	Land acquisition or land bank programs are based on the premise that land in a rapidly growing area such as Chino is less costly today than it will be in the future. Furthermore, those sites a district
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deems desirable for future school facilities may not be available if the district delays acquiring them until they are actually needed. Thus, in the district's land bank program, the district identified the future school sites it wished to acquire, as well as the approximate dates at which schools would be constructed on them.

The district established a nonprofit land bank corporation, which acquired the parcels on behalf of the district. The land bank program was structured so that the district would not be required to make lease payments for any parcel of land until after it needed the parcel for a new school or other district facility. The district would then make lease payments in accordance with the terms of the certificates of participation (certificates). The earliest of these lease payments for which the district is still liable is due in September 1994, and the final payments are due in September 2024. Alternatively, if funds, such as those from the State School Building Lease-Purchase Program or from a general obligation bond, are available to the district when lease payments begin to be due, then the district can pay off the certificates early. A third possibility is for the district to sell the land as surplus property and use the proceeds to pay off the certificates.

The district financed most of the cost of its land bank program by issuing the 1989 land bank certificates. On October 31, 1989, the funds raised through issuance of the land bank certificates totaled \$28,388,032. At September 30, 1991, the district's financial advisor accounted for the fund to acquire school sites as follows:

Original fund balance	\$ 28,388,032
Plus interest earned and funds transferred in	3,143,271
Less site acquisition payments	(15,606,346)
Less certificates prepaid	(15,836,109)
Less administrative fees	<u>(39,003)</u>
Remaining balance	<u>\$ 49,845</u>

The land bank corporation acquired ten sites totaling 121 acres for \$16.2 million. Approximately \$15.6 million of this total was financed with funds raised through the land bank certificates. The district paid off approximately \$15.8 million of the certificates early instead of acquiring school sites with the proceeds. It plans to obtain the funds to pay off the outstanding land bank certificates from the State School Building Lease-Purchase Program or from general obligation bonds.

**Cash
Management
Program**

Since December 1988, the district has invested its temporarily idle funds in a cash management program. The district started the cash management program as an alternative to investing district funds, particularly developer fees and district special tax revenues, solely in the San Bernardino County School District Investment Fund (county fund). The district collects a developer fee of \$1.58 per square foot on new development within the district to obtain school construction funds for specific school projects that must be related to the new development. Any person applying for a residential building permit within the district must pay the district's special tax, originally passed in 1980 and reapproved by the voters in 1983. The special tax revenues are for use in financing the construction of new school facilities and are currently under review at the State Supreme Court.

The funds invested in the cash management program are principally developer fees and district special tax revenues that the district has collected. At December 31, 1991, these funds accounted for approximately 80 percent of the total amount invested in the cash management program. In addition, since December 1990, the district has invested certain general funds and cafeteria funds in the cash management program and, since June 1991, has invested some county special tax revenues in the program that the San Bernardino County Treasurer's Office had collected on behalf of the district. The district intends to use the developer fee and its special tax funds that are invested in the cash management program to pay the lease obligations of the 1988 certificates.

At December 31, 1991, the financial advisor reported that the investments in the program had a value, based on the cost of securities, of \$18.3 million. This included \$7.6 million in the developer fee fund and \$7.0 million in the district special tax fund.

According to a memo from the district's former director of fiscal services, the county fund offers only short-term interest rates on school district investments. The Office of the County Superintendent of Schools confirmed that investments in the county fund earn the same short-term rate of return, adjusted quarterly, regardless of the amount invested in the fund. Thus, investments in the county fund are guaranteed a particular interest rate for only 90 days or less.

The district's objective in establishing the cash management program was to increase the rate of return on its investment by mixing investments of various terms. A financial advisor and an investment manager under contract with the district administer the cash management program for the district. The financial advisor is under contract to issue a monthly status report as well as an annual report on the program and periodic asset and liability analyses. The investment manager is responsible for the actual investment of funds in accordance with requirements of the contract and the California Government Code. Under the contract, the district is required to authorize certain changes to current investments and to program guidelines. Additionally, the investment manager issues a monthly statement of the investment portfolio for the district.

Arbitrage

Because the district has issued several certificates since 1986, it has to be concerned about arbitrage. Arbitrage is defined as the purchase of securities in one market for resale in another market to earn a profit. Local governments can arbitrage their investments by borrowing in the tax-exempt market (that is, issuing certificates or bonds) and investing those proceeds in the taxable market. For example, if a school district issued a \$5 million tax-exempt bond that paid 7 percent interest and then invested that \$5 million in corporate securities that paid 10 percent interest, the district could

pocket the earnings from the 3-percentage-point difference between the two interest rates. The federal Internal Revenue Code attempts to limit such earnings.

Section 103 of the Internal Revenue Code states that, with certain exceptions, the interest that buyers earn from state and local bonds is not included in the buyers' taxable income. One of those exceptions is if the bond is an arbitrage bond. According to the terms of Section 103, the interest earned on any arbitrage bond is not tax exempt under the code.

According to Section 148 of the Internal Revenue Code, to avoid having their bonds identified as arbitrage bonds, issuers of tax-exempt bonds must, with certain exceptions, pay the federal government the difference between the interest paid on the bonds and the interest earned from the investment of the bonds' proceeds. For example, in simplified terms, if a school district issues a bond at an interest rate of 7 percent and then invests the proceeds of the bond in securities that pay an interest rate of 10 percent, the school district will have to pay the federal government an amount equal to the 3-percentage-point difference between the two interest rates. This payment is called a "rebate." Section 148 requires bond issuers to pay this rebate at least once every five years.

Scope and Methodology

The purpose of this audit was to review the management of certain fiscal programs of the district that its contracted financial advisor administers, to determine the district's compliance with arbitrage and securities laws, and to examine potential conflicts of interest involving two members of the district school board and a district employee.

Management of Certain Fiscal Programs

We were asked to review the viability and management of, as well as the record keeping for, the following four district programs that are under the administration of a contracted financial advisor:

- The 1988 refunding certificates of participation financing program;
- The 1989 master lease program;
- The 1989 land bank certificates of participation financing program; and
- The cash management program.

We initially reviewed selected expenditures from the two certificate programs and the master lease program as reported by the financial advisor. We compared the expenditures the financial advisor reported as of September 30, 1991, with the district's records of disbursement requests and invoices. We found no disparity between the financial advisor's reports and the district's records. After this initial comparison, we focused the remainder of our review on the 1988 refunding certificates program, the 1989 land bank certificates program, and the cash management program.

To determine if the district's best interests are protected under its agreements with the financial advisor, we reviewed the terms and language of those agreements. Specifically, our objective was to determine if they contained clear and complete statements of the services to be provided, of the time requirements for performance or completion of the contracts, and of the maximum amount and basis upon which payment is to be made.

We also reviewed the district's implementation of certain recommendations made by its independent auditor in reports on the district's building program. Specifically, we reviewed the district's actions in implementing three of the nine recommendations from the report issued in 1990 and both recommendations from the report issued in 1991. We interviewed district personnel and reviewed records from the district's fiscal services and planning offices concerning implementation of the recommendations.

To assess the district's ability to make its lease payments under the 1988 and 1989 certificates, we requested that the district superintendent identify the sources of funds the district intends to

use to make lease payments under the certificates. We also asked whether the district had alternative plans should any of the intended sources be unavailable.

We reviewed the process for acquiring school sites under the 1989 land bank program to determine whether proper procedures were followed. In performing this review, we relied on the policies developed by the State Allocation Board for the acquisition of school sites.

Finally, we reviewed the return on investment of the cash management program in fiscal year 1990-91, as well as the district's compliance with selected investment requirements stated in the program's agreement. Our purpose was to determine whether the district's decision to invest its funds in the program was reasonable and prudent. Specifically, we compared the amount earned by investments in the cash management program with the equivalent earnings the district would have realized had a similar amount been invested in the county fund. In addition, we reviewed the composition of the cash management program's portfolio at June 30, 1991, to determine if it complied with certain requirements of the program's agreement.

Arbitrage and Rebate

We were asked to review the district's compliance with arbitrage laws. To identify applicable laws, regulations, and requirements concerning arbitrage and rebate, we reviewed the Federal Internal Revenue Code, the Code of Federal Regulations, texts covering arbitrage and rebate, and documents associated with the issuance of the certificates, such as official statements, rebate certificates, and no-arbitrage certificates.

To determine whether the district was in compliance with selected requirements concerning arbitrage and rebate for the 1988 and 1989 certificates, we interviewed the legal counsel for the certificates, the district's contracted financial advisor for the certificates, the district's contracted trustee for the certificates, and the district superintendent. We also reviewed the rebate calculations prepared for the 1987 and 1989 certificates.

During the audit, a concern was raised that the district may be subject to an arbitrage rebate liability if it transferred proceeds from the 1988 certificates program to its cash management program for investment purposes. To determine whether the district would be subject to such a rebate liability, we reviewed requests to transfer funds from the 1988 certificates program to the cash management program, reports issued by the district's contracted financial advisor for the certificates, and monthly statements issued by the district's contracted trustee for the certificates. We also interviewed the district's administrative director of business services.

Another concern raised during the audit was that the district may be subject to a rebate liability if it sold land at a profit that it had acquired using proceeds of the 1989 land bank certificates. To determine whether the district would be subject to such an arbitrage rebate liability, we reviewed portions of the California Education Code and the California Government Code concerning sale of public land. We also interviewed the legal counsel for the certificates and the district superintendent.

Compliance With Securities Laws

We were asked to review the district's compliance with securities laws. To identify applicable laws and regulations, we reviewed a text issued by the Municipal Securities Rulemaking Board (MSRB) and interviewed staff of the Securities and Exchange Commission. The MSRB was created by Congress in 1975 to regulate the activities of municipal securities brokers and dealers, so the rules of the MSRB focus primarily on the activities of municipal securities brokers and dealers. After reviewing these rules, we concluded that there was little of the district's participation in the several issuances of certificates that would be covered by the rules of the MSRB. For this reason, we conducted no further audit work in this area.

Conflicts of Interest

Concerns were raised that certain situations at the district created conflicts of interest. To identify applicable laws and regulations concerning conflicts of interest, we reviewed portions of the California Government Code and the California Code of Regulations, as well as opinions concerning conflicts of interest issued by the Fair Political Practices Commission (commission) and by attorneys for the district. We also reviewed a text covering conflicts of interest issued by the California Attorney General's Office, and we reviewed district policies and administrative regulations. Finally, we interviewed staff of the commission and of the Attorney General's Office.

Two of the alleged conflicts of interest concerned the sale of the district's certificates in 1989 by Gary Borcherding, a member of the district's school board who is also a broker for Shearson Lehman Brothers (Shearson Lehman), and the purchase of those certificates by Harold Nelms, another member of the school board. To determine whether the purchase and sale of the certificates by the school board members created conflicts of interest, we reviewed school board agendas and minutes, the district's personnel records, documents provided by Smith Barney, Harris Upham & Co. (Smith Barney) and by Shearson Lehman indicating dates that Smith Barney sold the certificates to Shearson Lehman, and documents showing the confirmation of sale of the certificates by Shearson Lehman to Mr. Nelms. We also interviewed Mr. Borcherding, Mr. Nelms, the district superintendent, and staff of Smith Barney and Shearson Lehman.

We were asked to review a potential conflict of interest involving a district employee, Dan Santo, who was also employed during 1990 by a contractor for the district. To determine whether this situation resulted in a conflict of interest, we reviewed the district's personnel records; reviewed agendas and minutes for school board meetings occurring from November 16, 1989, through January 17, 1991; reviewed chronological or correspondence files for Mr. Santo, his supervisors at the time, and the district superintendent; and reviewed statements of economic

interests completed by Mr. Santo for calendar years 1988, 1989, and 1990. Also, we interviewed Mr. Santo, the district superintendent, the board school members at the time of the alleged conflict of interest, and current and former district employees, including Mr. Santo's supervisors.

Chapter 1 The Chino Unified School District Could Improve Some Administrative Aspects of Its Building Program

Chapter Summary The Chino Unified School District (district) could improve some areas of the administration of its building program. For example, we reviewed three contracts between the district and a financial advisor associated with the district's building program. Two of the three contracts did not accurately state the basis upon which the district was to pay the financial advisor. Further, these two contracts did not contain clear and specific language about certain services to be provided and about the time frame for providing some services. Such weaknesses in contract language may leave the district unable to protect its best interests in the event of disagreements with contractors about payments due or about performance or timing of services. In addition, the district has not fully implemented all the audit recommendations contained in its independent auditor's reports on the building program issued in 1990 and 1991. These recommendations included the regular reconciliation of certain building program reports, the tracking of cash transfers, and the monitoring of budgeted-to-actual costs of the district's various building projects. The auditors also recommended that the district appoint a permanent staffperson to be responsible for preparing ongoing building program reports for district management. Failure to implement fully the auditor's recommendations may weaken the district's control over its building program assets and may result in essential information about the building program being unavailable to the district's board of education (school board).

**Contract
Language Not
Always
Accurate,
Specific, or
Clear**

The district has engaged a financial advisor to provide support for various aspects of the district's building program. Specifically, the financial advisor currently provides services under three separate contracts with the district, contracts that relate to the district's 1988 and 1989 certificates of participation (certificates) and to the district's cash management program. (See pages 2 and 3 for a description of certificates.)

We believe that the district could better protect its best interests through the inclusion of contract language similar to that required by the State Administrative Manual (manual). Specifically, Section 1200 et seq. of the manual includes certain requirements for state contracts that are intended to protect the best interests of the State. According to the manual, state contracts are to contain the following:

- A clear expression of the maximum amount and basis upon which payment is to be made;
- A clear and complete statement of the work, service, or product to be performed, rendered, or provided; and
- The time for performance or completion of the contract.

The district's contracts with the financial advisor for services related to the 1988 and 1989 certificates, which were approved by the district's school board, lacked language that fully protected the district's best interests. For example, the contract language relating to the calculation of the financial advisor's fees did not accurately describe the intended formula for calculating those fees, nor did it state that the fees were annual fees. Specifically, the contract relating to the 1988 certificates stated that, during the construction and installation period, the district was to pay a fee "not to exceed .15/1000 of the weighted average principal outstanding of certificates issued." According to the contract, this fee was to be paid semiannually. Based on this statement and the original principal of the certificates totaling \$43,855,000, the maximum fee due to the financial advisor was \$6,578, payable semiannually, calculated as follows:

$$(.15/1000) \times \$43,855,000 = \$6,578$$

This semiannual maximum fee would be the equivalent of a monthly maximum fee of \$1,096.

The contract relating to the 1989 certificates stated that the district was to pay the financial advisor a fee during the land acquisition period of ".10 percent per thousand of the weighted average principal outstanding." The fee was payable quarterly. Based on this statement and the original certificate principal of \$29,996,890, the fee due to the financial advisor was \$30, payable quarterly, calculated as follows:

$$(.10\%/1000) \times \$29,996,890 = \$30$$

The district did not pay the financial advisor for services under these two contracts according to the formulas described above. According to records prepared by the financial advisor for the 1988 certificates, during the 15-month period from November 1989 through January 1991, the district paid an average fee of \$3,000 per month. Similarly, records prepared by the financial advisor for the 1989 certificates show that, during the 16-month period from November 1989 through February 1991, the district paid an average fee of approximately \$2,500 per month.

The district superintendent stated that he believed the fees the district paid to the financial advisor appropriately reflected the intentions of the parties to the contract. However, the district could not fully explain the differences between the fees indicated by the language in the contracts and the fees the district actually paid. When we asked the financial advisor about the discrepancy, we were told that the fee structures intended under the two contracts were not as we have interpreted the contract language. Specifically, according to the financial advisor, the fee due from the district under the 1988 certificates contract was intended to be an annual fee, payable semiannually, not to exceed .15 percent of \$1,000 for each \$1,000 of the weighted average principal outstanding of certificates issued. Thus, the annual fee was intended to be calculated as follows:

$$(.15\% \times \$1,000) \times (\$43,855,000/\$1,000) = \$65,783$$

This equates to an average maximum monthly fee of \$5,482. However, the district actually paid an average of \$3,000 per month during the 15-month period we reviewed. According to the financial advisor, this amount was based on an oral agreement between the financial advisor, a district official, and a consultant to the district.

Similarly, according to the financial advisor, the fee due from the district under the 1989 certificates contract was intended to be an annual fee, payable quarterly, of .10 percent of \$1,000 for each \$1,000 of the weighted average principal outstanding of certificates issued. The annual fee was intended to be calculated as follows:

$$(.10\% \times \$1,000) \times (\$29,996,890/\$1,000) = \$29,997$$

This equates to an average monthly fee of approximately \$2,500, which is what the district actually paid during the period we reviewed.

Other Contract Weaknesses

In addition to the inaccurate language relating to fees in these two contracts, we found that the contracts related to the 1988 and 1989 certificates did not contain specific language about certain services to be provided and the time for performance of those services. Specifically, each of these contracts called for the financial advisor to assist the district or other parties in several activities, but neither contract specified who had final responsibility for the duties described. For example, the contract related to the 1988 certificates stated only that the financial advisor will assist in the selection of bond counsel; assist in the solicitation and evaluation of bond insurance proposals; assist in the preparation of certain financing documents; and assist in the analysis, development, implementation, and closing of the program for refinancing earlier certificates, constructing schools, and acquiring related facilities. The contract, however, did not state that the financial advisor was actually responsible for completing these duties, nor did it state the type or degree of assistance the financial advisor was to provide.

Additionally, each of these two contracts called for the financial advisor to prepare reports but did not specify the time frame within which the reports were to be provided. For example, the contract relating to the 1989 certificates stated that the financial advisor was to prepare certain periodical reports regarding all fund accounts, activities, and balances. However, the contract included no further specific timing requirements for preparation of these reports. Thus, one cannot determine from the contract language when or how frequently the financial advisor should have provided these reports to the district.

The district superintendent stated that the district has had no disputes with the contractor over fees or services. Nonetheless, because these two contracts did not contain clear and specific language, we could not verify that the fees the district paid to the financial advisor were appropriate, that the district received the services it expected to receive from the financial advisor, or that the district received the reports from the financial advisor at the times it required them. Furthermore, contracts with the type of problems we have identified may fail to protect the district's best interests under certain circumstances. For example, as a result of inaccurate statements of the basis of fees, the district may be unable to determine the proper fees due for contracted services, and it may pay more than it expected to pay for those services. It also may not receive the services it expected to receive under a contract, and it may not receive contracted services when it expects or requires them.

The district's contracts did not all contain clear and specific language about fees, certain services, or timing requirements because, according to the district superintendent, although the district uses a "boilerplate" for its service contracts, the district does not have a contracting procedures manual that requires the language added to the boilerplate to be specific and clear.¹

¹A boilerplate contains standard contract clauses to which the district can add specific language that pertains to a specific contract.

To clarify the contract language pertaining to fees, the district superintendent stated that the district will be recommending an amendment to the contract with the financial advisor. The proposed language of the amendment will more accurately reflect the original intentions of the district and the financial advisor.

**Some Audit
Recommen-
dations Not
Fully
Implemented**

The district requested its independent auditor to conduct a limited review of the district's building program for fiscal years 1989-90 and 1990-91. The results of the first review, reported in October 1990, found that some of the district's internal controls were weak and pointed out the importance of adequately monitoring certain fiscal and growth factors that may affect the building program and the district's ability to repay its debt. The auditor made a total of nine recommendations in the report. In October 1991, the auditor issued a second report. This report covered fiscal year 1990-91 on the district's building program and included two additional recommendations.

The district agreed to implement the recommendations of the independent auditor. For this reason and because implementation of the recommendations would improve the district's internal controls over its building program, we believe that the district should have taken the steps recommended by the independent auditor.

We reviewed the steps the district has taken to implement three of the nine recommendations from the fiscal year 1989-90 report. The three recommendations we reviewed were:

- The district should formally monitor budgeted-to-actual costs for each project in its building program and report the results to the school board;
- The district should track cash transfers between its cash management fund and its certificates; and

- The district should periodically reconcile the land bank detail reports of expenses with the trustee's cash balance.

We found that, although the district has taken some steps toward implementing two of the three recommendations, it has not fully implemented any of them. The district has taken steps toward regularly monitoring budgeted-to-actual costs for each project in that its business office prepared a plan calling for the district to prepare a budget-to-actual costs summary by project. However, the administrative director of business services acknowledged that the district has not implemented the plan on a regular basis.

Similarly, the district has prepared a spreadsheet for use in tracking cash transfer activity between its cash management fund and its certificates. However, the administrative director acknowledged that the district has not monitored the transfers on a regular basis. According to records prepared for the district by its financial advisor, four transfers from the cash management fund to the 1988 certificate construction fund, totaling \$3.14 million, occurred from November 1990 through September 1991. Finally, the district has not formally reconciled on a regular basis the detail status reports of the land bank program as prepared by the financial advisor with the cash balance in the land bank fund as reported by the trustee.

We also reviewed the steps the district has taken to implement the two recommendations from the fiscal year 1990-91 audit report. The two recommendations were:

- The district should fill the vacant position in its business office, a position that is responsible for compiling, reconciling, and summarizing building program activity into a report form for district management; and
- The district should continue to monitor cash flow, earnings, and the number of new residential units in the district as these factors relate to the district's building program and its ability to repay its debt.

We found that the district is monitoring the cash flow, earnings, and residential development information as the independent auditor recommended. However, as of February 6, 1992, the district had not assigned a permanent staffperson to the position of accounting technician who will be responsible for compiling, reconciling, and summarizing building program activity into report form for district management.

By not implementing the recommendations of its independent auditor, the district may reduce its level of control over its financial assets. For example, the monitoring or tracking of cash transfers among the components of the building program would aid the district in controlling its financial assets and ensuring the proper use of those assets. Further, the reconciliation of financial reports concerning the district's building program would provide a level of confidence that the information they contain is accurate and may be used in the decision-making process. Additionally, the district's failure to implement other recommendations of the independent auditor may result in essential information about the building program being unavailable to the district's school board. For example, the status of the budgeted-to-actual costs of the district's building program is information the school board needs to assess the progress of the program.

According to the administrative director of business services, the district has not fully implemented the three recommendations that we reviewed from the fiscal year 1989-90 report because of a vacancy in the position of accounting technician since August 1991. On February 6, 1992, the administrative director stated that the district would not fill the position for several months because it needs to rewrite the job description and to gauge the effect the new position will have on other positions in its fiscal services department. He stated that the district will comply with the recommendations as time allows until a permanent accounting technician is hired.

Conclusion The district could improve some areas of the administration of its building program. We reviewed three contracts between the district and a financial advisor associated with the district's building program. Two of the three contracts did not accurately state the basis upon which the district was to pay the financial advisor. Further, these two contracts did not contain clear and specific language about certain services to be provided and about the time frame for providing some services. Such weaknesses in contract language may leave the district unable to protect its best interests in the event of disagreements with contractors about payments due or about performance or timing of services. In addition, the district has not implemented all the audit recommendations contained in its independent auditor's reports issued in 1990 and 1991 on the building program. These recommendations included the regular reconciliation of certain building program reports, the tracking of cash transfers, and the monitoring of budgeted-to-actual costs of the district's various building projects. The auditors also recommended that the district appoint a permanent staffperson to be responsible for preparing ongoing building program reports for district management. Failure to implement the auditor's recommendations may weaken the district's control over its building program assets and may result in essential information about the building program being unavailable to the district's school board.

Recommendations To ensure that it protects its best interests, the district should include language in its future contracts that specifically and clearly identifies the services to be provided, the fees to be paid for those services, and the time frames within which those services will be provided. To ensure that this language is included in its future contracts, the district should develop and follow a contracting manual requiring that each of those areas identified be specifically and clearly addressed in all district contracts.

To ensure that it implements the independent auditor's recommendations, the district should make a permanent assignment to its vacant accounting technician position as soon as possible.

Chapter 2 We Found No Weaknesses in Some Areas of the Building Program at the Chino Unified School District

Chapter Summary During our audit, we found no weaknesses in several areas of the Chino Unified School District's (district) management of its building program. For example, we reviewed the district's ability to make the lease payments required by two of the district's certificates of participation (certificates). Although the district is aware that some of the anticipated sources of revenues may not be available when the lease payments must start, it has identified alternative revenue sources with which it could make the lease payments. Further, we reviewed the procedures that the district followed in acquiring parcels of land through its land bank program and found them to be reasonable. We also reviewed the earnings of the district's cash management program in fiscal year 1990-91 to determine whether the district made a reasonable and prudent decision to invest its funds in the program. Our review indicated that the district earned approximately \$640,000 more than it would have earned had it invested the funds in the San Bernardino County School District Investment Fund. Finally, the district, when required, complied with federal requirements to calculate arbitrage rebate for the 1987 certificates.

Sources of Funds for Making Lease Payments According to the official statements for the 1988 and 1989 certificates, which provide detailed information about the district and about the sale, delivery, and amounts of the certificate issuances, the district agreed to include in its annual budgets an amount sufficient to allow it to make all required lease payments. (See pages 2 and 3 for a description of certificates.) The official statements did not specify the district's sources of funds from

which the payments would be made; however, the district superintendent stated that the district intended to make the lease payments required by the 1988 certificates with funds from a special tax and from developer fees. (See page 5 for a description of the special taxes and the developer fee.) Additionally, he stated that the district intended to make the lease payments required by the 1989 certificates with funds from the State School Building Lease-Purchase Program or from general obligation bonds.

According to its superintendent, the district is aware that some of the funding sources may not be available when the lease payments must start. For example, the State Supreme Court is currently reviewing a decision by the Court of Appeal that the district's special tax is invalid under the California Constitution and may be in violation of the California Government Code. The ultimate decision of the court should determine whether the district is able to retain this revenue source to make lease payments. Nonetheless, the district superintendent stated that another special tax, approved by voters and authorized by the county board of supervisors in 1983 and to be assessed on 10,000 new homes to be constructed in the City of Chino Hills, will provide sufficient revenues for the district to continue making its lease payments under the 1988 certificates even if the original special tax is lost.

Additionally, funding from the State School Building Lease-Purchase Program may not be available to the district for obligations due under the 1989 certificates. Funds from this program are distributed to school districts through the State Allocation Board. School districts must apply for these funds, which are subsequently allocated to school districts according to a priority system. A school district's priority may be affected by its ability to fund 50 percent of a project's cost, its adoption of a year-around education program, or its efforts to reduce its eligibility for these funds. The priority system exists because of the overall limited availability of state funds with which to meet all school district requests. Because of the priority system and limits to the availability of funds, the district is not assured that it will receive funding from this source to help make its lease payments. Thus far,

according to its superintendent, the district has received funding from the State School Building Lease-Purchase Program for one of the land bank projects.

The district superintendent stated that the district may issue general obligation bonds to obtain funds for its lease payments under the 1989 certificates. According to Section 15124 of the California Education Code, two thirds of the votes cast during an election must be in favor of issuing school district bonds. Because of this restriction on the district's ability to issue bonds, it is uncertain whether bond funds will be available to the district. Additionally, school districts have an overall bond debt limit equal to 2.5 percent of the district's taxable property. According to the district superintendent, the district's current bond debt is \$11.95 million, or approximately 10 percent of its overall bond debt limit of \$120 million.

The district superintendent stated that, if sufficient funds to make lease payments under the 1989 certificates are not available from the State School Building Lease-Purchase Program or from general obligation bonds, the district will consider selling the sites acquired under the program and use the proceeds to pay off the certificates. He further stated that the sites should have sufficient appreciated value to retire the certificates with the proceeds of such a sale.

**Review of the
District's
Acquisitions of
Three
Properties**

As part of its building program, the district's land bank has purchased ten parcels of land on which the district plans to construct new elementary and junior high schools and a district administrative facility. (See pages 3 through 5 for a description of the district's land acquisition program.) The land bank spent a total of \$16.2 million on these sites, which was raised from the 1988 and 1989 sales of certificates.

We reviewed a sample of three of these ten acquisitions to determine whether the land bank followed sound procedures in purchasing each of these parcels. In performing this review, we

relied on policies contained in a handbook developed by the Office of Local Assistance. Under the Leroy F. Greene State School Building Lease-Purchase Law of 1976 (lease purchase law), the State Allocation Board is empowered to adopt policies, procedures, and regulations that are applicable to school districts seeking state funds for the replacement, reconstruction, or acquisition of school facilities, including sites on which new schools will be built. The Office of Local Assistance serves as staff to the State Allocation Board.

We applied a selection of these policies, procedures, and regulations to the three acquisitions that we reviewed. In our judgment, these policies offer a reasonable set of procedures to guide school district officials and the district's land bank in the proper and prudent use of local funds to acquire needed parcels of land.

In performing our review of the three acquisitions, we determined that the district's land bank generally followed each of the several policies for which we reviewed. Specifically, the land bank considered parcels other than the one ultimately purchased or provided a reasonable justification for considering only one parcel. Additionally, the land bank obtained approval from the California Department of Education, as required by the California Education Code, that the chosen parcel was a suitable site for a school. Furthermore, the land bank involved legal counsel in the acquisition of the parcel by having counsel review the preliminary title report and the escrow instructions to ensure that the district's best interests were protected. Also, for the one parcel for which the district has received state funding, the amount that the State allocated for the acquisition of the parcel was in accordance with the policies of the State Allocation Board.

We took exception to one component of one of the acquisitions in our review, however. For this acquisition, in which the land bank purchased a 20.6 acre parcel that the district planned to use as the site of a new elementary and junior high school, the district could not provide us with a copy of an independent appraisal of the value of the parcel that had been completed before the purchase of

the property. Although the district did obtain an appraisal two months after the land bank had already purchased the parcel, the independent appraisal should have been completed before the purchase.

For the other two site acquisitions that we reviewed, the district did obtain an independent appraisal of the value of the parcels before buying the site, and the price that the land bank ultimately paid for the parcels was consistent with the independent appraisal.

According to the district superintendent, the district did not contract to obtain its own appraisal before the land bank purchased the 20.6 acre property because the district felt that it had sufficient evidence that the price the land bank offered the seller of \$212,500 an acre was reasonable. In May 1991, one month before the sale closed between the seller and the land bank, the district obtained a copy of an appraisal that had been done on the 92 acres that included the 20.6 acre parcel eventually purchased. This appraisal, which was done for a southern California developer, concluded that the property was worth \$189,300 an acre.

According to the independent appraisal, which was done for the district in August 1991, two months after the sale was completed, the parcel was worth \$215,000 an acre, which is \$2,500 more than the land bank paid per acre for the parcel.

Also, at the same time the land bank was buying this 20.6 acre parcel, the city of Ontario was buying a 7.1 acre parcel adjacent to the school site. The city of Ontario and the district plan to use this site jointly as a city park and a school playground. The city of Ontario paid the same price for the 7.1 acres as the land bank paid for the 20.6 acres, that is, \$212,500 per acre. Thus, even though the district did not obtain an appraisal before the land bank purchased this property, it appears that the district had sufficient evidence that the price paid for this school site was reasonable, and the district was not harmed by its failure to obtain an independent appraisal before the purchase of the parcel.

**Cash
Management
Program**

The district began investing temporarily idle funds in a cash management program in 1988. (See pages 5 and 6 for a description of the cash management program.) The cash management program was intended as an alternative to investing funds in the San Bernardino County School District Investment Fund (county fund). Although the county fund offers a safe investment and high liquidity to the district, it pays a single rate of return, adjusted quarterly, to all investors without regard for the amount of money invested or the length of time it is invested. Alternatively, the cash management program distributes the district's funds among short-term, medium-term, and long-term investments of different types.

We assessed the earnings of the cash management program by reviewing the program's return on investment, after payment of required fees, and its compliance with contract requirements pertaining to term of investments. One of the district's goals is to earn a higher return on the investment, after payment of required fees, in the cash management program than it would have earned if a comparable amount was invested in the county fund. Additionally, district investments in the cash management program should be in compliance with the investment requirements of the California Government Code.

Our review showed that, in fiscal year 1990-91, the cash management program yielded a higher return on investment, after payment of fees, than a comparable investment in the county fund would have yielded. Specifically, the district reported a net return on its investment of approximately \$2.44 million in the cash management program. Based on our computation of the average investment balance in the cash management program during the fiscal year, a similar amount invested in the county fund over the same period would have yielded a net return of approximately \$1.8 million.² Thus, we estimate that the district earned approximately \$640,000 more by investing its funds in the cash management program than it would have earned by investing in the county fund.

²This assumed that the starting balance in the county fund would have been equal to the reported balance in the cash management program at July 1, 1990.

The district incorporated the requirements found at Section 53601 of the California Government Code into the investment guidelines stated in the contract for the cash management program. This section specifies those authorized investments that local agencies, including school districts, may make with their temporarily idle funds. For example, the Government Code and the contract allow no more than 40 percent of a district's invested funds to be in bankers' acceptances and specify that the term of such investments may not exceed 270 days. In addition, the district included some investment requirements that are not part of the Government Code. Thus, the investment requirements of the cash management program are at least as restrictive as the Government Code requirements.

To assess the district's compliance with the contract requirements pertaining to term of investments, we reviewed the distribution of the program's investments at June 30, 1991, as reported by the district's financial advisor. The contract requires that the investment portfolio consist of a minimum of 15 percent short-term investments, a maximum of 85 percent medium-term investments, and a maximum of 40 percent long-term investments.

The district's portfolio, as described in the financial advisor's summary, complied with the investment guidelines in the contract agreement pertaining to term. Specifically, the portfolio at June 30, 1991, consisted of 22.6 percent short-term investments, 43.1 percent medium-term investments, and 34.3 percent long-term investments.

Because these guidelines are at least as restrictive as the requirements in the California Government Code, we conclude, based on our review, that the program's investments at June 30, 1991, complied with the guidelines for term of investment as stated in the program agreement and, thus, complied with the corresponding Government Code requirements.

**Concerns
About Arbitrage
and the District**

From 1986 through 1989, the district participated in issuing several certificates and other similar lease financing documents. Because the district did not immediately spend all of the proceeds of these certificates, it invested some of the proceeds. By investing these proceeds, the district had the opportunity to arbitrage its investments. As a result, the district may have been required to “rebate” to the federal government an amount equal to the difference between the interest rate the district paid on the certificates and the interest rate it earned from investing the certificates’ proceeds. (See pages 6 and 7 for additional information about arbitrage and rebate.)

In response to concerns about potential rebate liability, we reviewed the district’s compliance with selected arbitrage and rebate requirements. We also examined evidence to determine whether the district might incur a potential rebate liability if it transferred proceeds from the 1988 certificates into its cash management program for investment purposes or if it sold land it acquired with proceeds from the 1989 certificates.

Compliance With Selected Federal Arbitrage Requirements

The federal Internal Revenue Code requires the issuers of bonds and similar types of debt instruments that are tax exempt to pay any potential rebate to the federal government at least once every five years for the life of the debt instrument. The Internal Revenue Code also requires these issuers to pay the rebate within 60 days after the end of the life of the debt instrument. These requirements are effective for governmental debt instruments issued after August 31, 1986.

For the 1986 certificates, the district did not have to comply with the federal requirements to pay any potential rebate because these certificates were issued on August 28, 1986, three days before the effective date of the requirements.

The district used a portion of the proceeds from the 1988 certificates to retire the outstanding 1987 certificates early. As required, one of the district's contractors prepared the rebate calculations, dated December 17, 1988, for the 1987 certificates. The calculations stated that the district did not owe any rebate to the federal government.

For the 1988 and 1989 certificates, the district is not yet required to pay a rebate to the federal government because the five-year time period has not yet elapsed. The 1988 certificates were issued on July 28, 1988. Therefore, if the district does not retire the 1988 certificates early, rebate calculations for the first five-year period do not need to be prepared until September 1993. The 1989 certificates were issued on October 31, 1989. If the district does not retire the 1989 certificates early, rebate calculations for the first five-year period do not need to be prepared until December 1994.

Although the district is not required to prepare the rebate calculations for the 1989 certificates until December 1994, a financial services firm issued a report in January 1992 indicating the district's rebate liability as of October 31, 1991. According to the district superintendent, the calculations were prepared because the district no longer has any idle funds from the 1989 certificates. These calculations indicate that the district did not owe any rebate to the federal government for the 1989 certificates.

Compliance With Other Selected Requirements

Although the district complied with applicable federal requirements concerning payment of rebates at least once every 5 years or upon the retirement of the debt instrument, it has not complied with another requirement. According to agreements entered into by the district and the trustee when they arranged to issue the 1988 and 1989 certificates, the district is responsible for the preparation of annual rebate calculations. According to the legal counsel and the trustee for the certificates, this annual calculation is required to ensure that the district is aware of its potential rebate liability on an ongoing basis and that it has enough funds set aside to pay any potential rebate to the federal government.

As of March 31, 1992, the district has not prepared five annual rebate calculations for these two certificates. For the 1988 certificates, annual calculations are due by mid-August of each year. Since the issuance of the certificates on July 28, 1988, the district has missed annual calculations for 1989, 1990, and 1991. For the 1989 certificates, annual calculations are due by late April of each year. Since the issuance of the certificates on October 31, 1989, the district has missed annual calculations for 1990 and 1991.

The district has not prepared the annual rebate calculations for the 1988 and 1989 certificates because it does not believe it is required to. According to the district superintendent, federal requirements call for paying a rebate only at least once every five years, not annually.

To determine whether they had any concerns about the district's not complying with the requirement to calculate rebates annually, we contacted staff of the district's trust association and legal counsel for the certificates. An assistant vice president for the trust association stated that the trust association is not yet concerned about the district's lack of compliance regarding the 1988 certificates because the district has enough proceeds remaining from these certificates to pay any potential rebate. She further stated that the association is not concerned about the district's lack of compliance regarding the 1989 certificates because the rebate calculations have already been prepared.

An attorney for the legal counsel for the certificates stated that the district should be able to comply with federal requirements if it monitors its arbitrage rebate liability through means other than an annual rebate calculation and if it sets aside or otherwise provides sufficient funds to pay the liability. According to the district superintendent, the financial advisor monitors the district's potential rebate liability by periodically comparing the actual amount of interest the district has earned with the maximum amount of interest earnings the district could retain before paying any potential rebate liability.

Transfers From the 1988 Certificates

Because a report issued by the district's independent auditor indicates that the district was transferring proceeds from the 1988 certificates to the district's cash management program, concerns were raised that the district might incur a rebate liability if these transfers were made for investment purposes.

To determine whether the district transferred proceeds from 1988 certificates to the cash management program to invest those proceeds, we obtained and reviewed district records of these transfers. These records indicate that, from December 1988 through September 1989, the district made six transfers totaling \$10.2 million to the cash management program.

The written requests for these six transfers stated that the purpose of the transfers was for payment or reimbursement for costs incurred or expenditures made in connection with the projects associated with the 1988 certificates. The requests did not state that the transfers were made to invest the proceeds. In other words, the district advanced funds from the cash management program to the projects for the 1988 certificates, and the six transfers were simply reimbursements for these advances.

To verify that the transfers were made for the stated purposes, we reviewed supporting documentation such as invoice summaries associated with the transfers. This documentation indicated that the district was reimbursing the cash management program for services made in connection with the certificates' projects. Therefore, we found no evidence that the district was transferring proceeds from the 1988 certificates to the cash management program for investment purposes.

Potential Sale of District Land

Concerns were also raised that the district might incur a rebate liability if it sold some of the land that it had acquired using proceeds from the 1989 certificates. This concern arose because, if

the district profited from the sale of the land, the Internal Revenue Service might believe that the district bought the land for investment purposes, rather than for future school sites.

To determine whether the district would be subject to a potential rebate liability if it profited from the sale of any land it purchased with proceeds from the 1989 certificates, we interviewed an attorney from the legal counsel for the certificates. According to this attorney, if the district elects to sell any of the land it purchased, it is required to sell the land in compliance with Section 39360 et seq. of the California Education Code. Under these provisions, the district is required to offer to sell or lease the property for public projects such as low-income or moderate-income housing, parks, recreation, or open space. If the district decides to sell the land without following these provisions, it is required by the terms of the financing documents to obtain an opinion from a legal counsel stating that the sale methods used will not jeopardize the tax-exempt status of the interest paid on the certificates.

According to the district superintendent, if the district does sell any land that it acquired using proceeds from the 1989 certificates, it intends to comply fully with the sale requirements stated in the California Education Code and in the financing documents.

Conclusion

We reviewed several components of the district's management of its building program. We assessed the district's ability to make its lease payments under the district's certificates, we reviewed the procedures followed by the district in acquiring future school sites through its land bank program, we reviewed the earnings of the district's cash management program in fiscal year 1990-91 to determine whether the district made a reasonable and prudent decision to invest its funds in the program, and we reviewed the district's compliance with arbitrage requirements. We found that, although the district is aware that some of the anticipated sources of revenues may not be available when certificate liabilities become due, it has identified alternative revenue sources with which it

could meet these financial liabilities. Further, the district generally followed reasonable procedures in acquiring future school sites through its land bank program. We also found that the cash management program earned a return of approximately \$640,000 more than it would have earned had the funds been invested in the county fund. Finally, the district has complied with federal requirements to calculate arbitrage rebate for the certificates it participated in issuing in 1987. The district has calculated arbitrage rebate liability for the 1987 certificates, which up to now is the only series of certificates for which the calculation of an arbitrage rebate has been required.

Chapter 3 Alleged Conflicts of Interest at the Chino Unified School District

Chapter Summary

We received allegations that conflicts of interest may have occurred at the Chino Unified School District (district) because, in 1989, one member of the district's board of education (school board) sold some of the district's certificates of participation (certificates) to another member of the school board and because, during 1990, an employee of the district was also employed by a contractor for the district. After conducting an extensive review, we cannot conclude that these situations violated state laws concerning conflicts of interest involving local public officials.

Laws Concerning Conflicts of Interest

We received allegations that two situations may have resulted in conflicts of interest at the district. Three different portions of the California Government Code pertain to conflicts of interest involving local public officials. The first portion consists of Sections 1090 et seq. These sections relate to conflicts of interest involving contracts. Violations of Sections 1090 et seq. can occur if, in their official capacity, public officials or employees participate in the making of a contract in which they have a financial interest.

The second portion of the Government Code dealing with conflicts of interest is Sections 1125 et seq. These sections relate to conflicts of interest involving outside activities for which public officials or employees are compensated and that are inconsistent or incompatible with their public duties.

Section 1126 describes four broad types of outside activities that may be considered incompatible and, therefore, can be prohibited. According to the code sections, activities can be prohibited under the following circumstances:

- The activity involves the use of the public agency's time, resources, uniforms, or prestige;
- An official receives private payment for the performance of an activity that the official is required to perform in his or her public capacity;
- The result of the outside activity will ever be subject to control or audit by the public agency; or
- The outside activity makes such great demand on an official's time that the official is hampered in the performance of his or her public duties.

The application of Section 1126 differs for public officials who are members of a school board versus those who are not members of a school board. For a local public official or employee who is not a member of a school board to violate Section 1126, the employing agency must have adopted a statement of incompatible activities. Statements of incompatible activities identify those outside activities that the employing agency has determined to be inconsistent with, incompatible to, or in conflict with the duties as a public official or employee of the agency. For a member of a school board to violate Section 1126, the school district need not have an adopted statement of incompatible activities.

The third portion of the California Government Code dealing with conflicts of interest is Sections 87100 et seq. These sections relate to conflicts of interest involving public officials or employees making governmental decisions that could affect their financial interests. Public officials or employees are prohibited from making, participating in the making of, or using their official positions to influence the making of a governmental decision if it is reasonably foreseeable that this decision could materially affect their financial interests and if the effect of the decision on the

financial interest is distinguishable from its effect on the public generally.

Section 87103 of the Government Code defines five types of financial interests: (1) sources of income of \$250 or more provided to, received by, or promised to a public official or employee in the 12 months preceding a decision; (2) investments of \$1,000 or more in a business entity; (3) donors of gifts of \$250 or more provided to, received by, or promised to a public official or employee in the 12 months preceding the decision; (4) any real property in which the public official or employee has interests worth \$1,000 or more; and (5) any business entity in which the public official or employee is an officer, director, partner, trustee, manager, or employee.

**Allegations of
Conflicts of
Interest
Involving Two
School Board
Members**

On October 10, 1989, the district's school board, by a 5-0 vote, approved the issuance of certificates in an amount not to exceed \$30.0 million. (See pages 2 and 3 for a description of certificates.) At this time, the district also approved an agreement with Smith Barney, Harris Upham & Co. (Smith Barney) to underwrite the certificates. The district planned to use the proceeds generated from the sale of these certificates to acquire land for future school sites. Gary Borcherding and Harold Nelms were members of the school board at the time of the vote.

During a meeting of the board's members on October 19, 1989, Mr. Nelms stated that, as a show of support, he would like to purchase some of the district's certificates. According to both Mr. Borcherding and Mr. Nelms, Mr. Borcherding contacted Mr. Nelms on October 20, 1989, to confirm his desire to acquire some of the district's certificates. Mr. Borcherding stated that he was a broker for Shearson Lehman Brothers (Shearson Lehman) during 1989 and that Mr. Nelms was one of his clients. Mr. Borcherding added that, after Mr. Nelms confirmed his interest, he contacted Smith Barney, the underwriting firm, and learned that all of the district's certificates had not yet been sold. Then, according to Mr. Borcherding, he requested another of Shearson Lehman's employees to arrange a sale of a portion of the certificates between Smith Barney and Shearson Lehman.

On October 23 and 24, 1989, Smith Barney sold certificates with a face value of a total of \$500,000 to Shearson Lehman. On October 25, 1989, Mr. Nelms purchased certificates with a face value of \$20,000 from Shearson Lehman.

According to Mr. Borcherding, he earned a total commission of \$320 for selling the district's certificates—a commission of \$80 for the sale of the certificates to Mr. Nelms and commissions totaling \$240 for sales of the certificates to others.

On August 14, 1990, approximately ten months after his acquisition of the certificates, Mr. Nelms, on advice of the district's legal counsel, cancelled the transaction. According to Mr. Nelms, he did not profit from the purchase of the certificates nor from the subsequent cancellation of the transaction. Also, according to Mr. Borcherding, in August 1990, he returned the \$320 in commissions to Shearson Lehman on advice of the district's legal counsel.

Government Code, Sections 1090 et seq.

To violate Sections 1090 et seq. of the Government Code, public officials or employees must have a financial interest in a contract. To determine whether Mr. Borcherding or Mr. Nelms had a financial interest in a contract issued by the district related to the 1989 land bank certificates, we checked to see whether the district had a contract with Shearson Lehman, Mr. Borcherding's employer. According to the district superintendent, the district did not contract with Shearson Lehman for any tasks associated with the district's 1989 land bank certificates.

Although the district did not contract with Shearson Lehman for tasks associated with the 1989 land bank certificates, on October 10, 1989, the same date that it approved the issuance of the certificates, the school board approved various agreements related to the certificates, including one with Smith Barney for underwriting services. It could be argued that, if Mr. Borcherding and Mr. Nelms knew or had reason to know at the time of their approval of the contracts for the 1989 certificates that they would

later benefit from the retail sale of the certificates, they may have had a financial interest in the contract.

The evidence we collected, however, does not indicate that Mr. Borcherding or Mr. Nelms had a financial interest in the district's contracts related to the 1989 certificates. According to Mr. Borcherding, he did not know or otherwise have reason to know that, when he voted to approve the issuance of the certificates, Shearson Lehman would later participate in the sale of some of the district's certificates or that he would later earn commissions for the sale of the certificates. Mr. Nelms also stated that he did not know or otherwise have reason to know that, when he voted to approve the issuance of the certificates, he would later purchase some of the certificates. Furthermore, during the course of the audit, we neither found nor were provided with other information indicating that Mr. Borcherding or Mr. Nelms did in fact know or have reason to know that they would later be involved in the retail sale of the certificates. Therefore, we cannot conclude that Mr. Borcherding's sale of the certificates or Mr. Nelms's purchase of the certificates violated Section 1090 of the Government Code.

Government Code, Sections 1125 et seq.

Sections 1125 et seq. of the Government Code relate to conflicts of interest involving outside activities for which public officials or employees are compensated and that are inconsistent or incompatible with their public duties. According to Mr. Borcherding, he earned a total of \$320 in commissions for selling the district's certificates to Mr. Nelms and to others. Therefore, because Mr. Borcherding was a broker for Shearson Lehman, we consider Mr. Borcherding's sale of the certificates to be an outside activity for which he was compensated.

However, the evidence we collected does not indicate that Mr. Borcherding's sale of the district's certificates was incompatible with his duties as a member of the school board for two reasons. First, according to the district superintendent, the sale of the certificates did not involve the use of any of the district's

time or resources; Mr. Borcherding did not receive payment from the district for the sale of the certificates; the sale of the certificates was not subject to control or audit by the district; and the sale did not make such great demands upon Mr. Borcherding's time that it hampered his performance on the school board. Second, according to Mr. Borcherding, he returned to Shearson Lehman the \$320 in commissions he received for selling a portion of the district's certificates. Therefore, based on the above statements, we cannot conclude that Mr. Borcherding's sale of the district's certificates violated Section 1126 of the Government Code.

Also, the evidence we collected does not indicate that Mr. Nelms's purchase of the certificates was an outside activity for which he was compensated. Mr. Nelms purchased certificates with a face value of \$20,000 from Shearson Lehman on October 25, 1989. According to Mr. Nelms, he cancelled his purchase of the certificates the following August on the advice of the district's legal counsel. Mr. Nelms also stated that he made no profit from the purchase of the district's certificates and subsequent cancellation of the purchase. Thus, based on his statements, Mr. Nelms never realized any compensation for his purchase. Therefore, we cannot conclude that Mr. Nelms's purchase of the district's certificates violated Section 1126 of the Government Code.

Government Code, Sections 87100 et seq.

Sections 87100 et seq. of the Government Code concern conflicts of interest involving public officials or employees making or participating in the making of governmental decisions that could affect financial interests they have. To violate Sections 87100 et seq., public officials or employees must make or participate in the making of a governmental decision that could materially affect their financial interests.

The evidence we collected does not indicate that Mr. Borcherding's sale of the district's certificates and the commission he earned from that sale constituted a financial interest. According to Mr. Borcherding, he earned \$320 in

commissions for selling the district's certificates to clients of Shearson Lehman. This \$320 exceeds the \$250 income limit established in the Government Code. However, Mr. Borcherding began earning these commissions on October 25, 1989, the date Mr. Nelms purchased the certificates. This date was 15 days after he voted to issue the certificates. According to the requirements in the Government Code, the income must be received at some point during the 12 months before a decision. Because Mr. Borcherding did not earn the income until after he voted to issue the certificates and because he stated that, at the time of the vote, he did not know that Shearson Lehman would later be selling some of the district's certificates, we cannot conclude that Mr. Borcherding's sale of the certificates violated Sections 87100 et seq.

The evidence we collected also does not indicate that Mr. Nelms's purchase of the certificates constituted a financial interest. As stated earlier, the requirements of the Government Code state that income must be received at some point during the 12 months before a decision is made. Mr. Nelms purchased the certificates on October 25, 1989, 15 days after he voted to issue the certificates. Additionally, Mr. Nelms stated that, at the time he voted, he did not know that he would later be purchasing some of the district's certificates.

Moreover, although the \$20,000 face value of the certificates purchased by Mr. Nelms exceeds the \$1,000 investment limit established in the Government Code, the school district is not a business entity. Thus, Mr. Nelms's purchase of the certificates cannot be considered an investment in a business entity. Therefore, we cannot conclude that Mr. Nelms's purchase of the certificates violated Sections 87100 et seq.

**Allegations of a
Conflict of
Interest
Involving a
District
Employee**

In a letter dated November 20, 1989, Dan Santo resigned his position as the district's director of planning and facilities, effective January 5, 1990. According to the district superintendent, he asked Mr. Santo to stay with the district until a replacement could be found. In a letter to Mr. Santo dated December 4, 1989, the district superintendent confirmed that Mr. Santo's resignation had

been rescinded and that Mr. Santo was to be retained at the district on a half-time basis as long as the district required his services but no later than March 30, 1990.

On January 8, 1990, Mr. Santo started work as the managing director of educational services with the district's contracted financial advisor. On February 26, 1990, Mr. Santo requested that his resignation be withdrawn and that his employment with the district continue on a half-time basis; he would continue also to work for the financial advisor.

On December 3, 1990, Mr. Santo resigned his position with the district effective January 4, 1991. Therefore, from January 8, 1990, through January 4, 1991, Mr. Santo worked for both the district and the district's financial advisor.

Government Code, Sections 1090 et seq.

To violate Sections 1090 et seq. of the Government Code, public officials or employees must have a financial interest in a contract. We identified one contract that the school board approved with the financial advisor during Mr. Santo's employment by both the district and the financial advisor. The contract was with the financial advisor to assist with the district's cash management program. (See pages 5 and 6 for a description of this program.)

To determine whether Mr. Santo participated in making this contract with the financial advisor, we reviewed school board agendas and minutes, and we reviewed correspondence files for current and former district employees. We also interviewed the district superintendent, school board members, and employees who were with the district at the time the school board approved the contract. We did not find nor were we provided with evidence that Mr. Santo participated in the making of this contract. Therefore, we cannot conclude that Mr. Santo's employment by both the district and the financial advisor violated Section 1090 of the Government Code.

Government Code, Sections 1125 et seq.

Sections 1125 et seq. of the Government Code relate to conflicts of interest involving outside activities for which public officials or employees are compensated and that are inconsistent or incompatible with their public duties. According to the California Attorney General's Office, Sections 1125 et seq. can be applied to employees of a local agency only if the local agency has a statement of incompatible activities. According to its superintendent, the district does not have a statement of incompatible activities. Therefore, we did not apply Sections 1125 et seq. to the situation in which Mr. Santo was employed by both the district and by the district's contracted financial advisor.

Government Code, Sections 87100 et seq.

Sections 87100 et seq. of the Government Code relate to conflicts of interest involving public officials or employees making or participating in the making of governmental decisions that could affect financial interests they have. From January 8, 1990, through January 4, 1991, Mr. Santo had an economic interest for two reasons. First, he received income totaling more than \$250 from the district's financial advisor. Second, he held an employment position with the district's financial advisor.

To determine whether Mr. Santo made or participated in the making of governmental decisions that may have materially affected his financial interests when he was employed by both the district and the district's financial advisor, we reviewed agendas and minutes of school board meetings occurring from November 16, 1989, through January 17, 1991, and we reviewed chronological files or correspondence files of Mr. Santo, the district superintendent, Mr. Santo's two supervisors at the district, and the district's former administrative director of business services. We also interviewed the five individuals who sat on the district's school board at this time, the district superintendent, Mr. Santo's two supervisors at the district, the district's former administrative director of business services, and Mr. Santo.

We did not find nor were we provided with evidence that Mr. Santo made or participated in the making of a governmental decision that may have materially affected his financial interests. Therefore, we cannot conclude that Mr. Santo's concurrent employment with the district and the district's financial advisor violated Sections 87100 et seq. of the Government Code.

Conclusion

We received allegations that conflicts of interest may have occurred at the district because one school board member sold some of the district's certificates to another school board member and because an employee of the district was simultaneously employed by a contractor for the district. After conducting an extensive review, we cannot conclude that these situations violated state laws concerning conflicts of interest involving local public officials.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG
Auditor General (acting)

Date: June 29, 1992

Staff: Steven M. Hendrickson, Audit Manager
Dale A. Carlson
Thomas P. Roberson



CHINO UNIFIED SCHOOL DISTRICT

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June 24, 1992

Mr. Kurt R. Sjoberg
Auditor General (acting)
Office of the Auditor General
660 J Street, Ste 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

On behalf of the Chino Unified School District, I want to thank the staff of the Auditor General's Office for the thoroughness of their audit, the unfailing courtesy they extended to our staff, the process utilized and the recommendations contained in the final report. The extensive audit, the findings and recommendations, and the final report will be useful as the District moves ahead in discharging its responsibilities.

In response to the recommendations, we intend to do the following:

CONTRACT LANGUAGE NOT ALWAYS ACCURATE, SPECIFIC OR CLEAR

Although the District has been using a standard contract form with language developed by County Counsel and, in some cases, individual contract review by legal counsel, it is felt that the recommendation is a sound one. The State Administrative Manual which contains requirements for state contracts has been ordered from the Department of General Services. The information from both of these sources will assure that contracts protect the best interests of the District.

In response to the issue of fees, the administration will recommend to the governing board that specific changes be made to the appropriate contracts reflecting accurate and proper fees to be paid for services received.

SOME AUDIT RECOMMENDATIONS NOT FULLY IMPLEMENTED

The report refers to the 1990 and 1991 special audits of the building programs that the District requested from its independent auditors, Vavrinek, Trine, Day & Co. The June 30, 1991, report indicated that all nine recommendations made in the prior year audit report had been implemented.* In addition, two recommendations were added in the 1991 report. One recommendation was that the District should fill the vacant accounting technician position. The other was that the District should continue to monitor and adjust projections of new dwelling unit construction and its impact on developer fee and special tax revenue projections. The District has filled the vacant accounting technician position as of April 1992, has continued to monitor new housing construction, and has modified projections of special tax and developer fee income as appropriate. Since filling the vacant accounting technician position in April 1992, significant progress has been made in complying with the Auditor General's recommendations.

Although not included as a recommendation, and Chapter 2 states that the District was not harmed in the purchase of 20.6 acres, there are two conditions which are not reported but should be known. The first involves the fact that the purchase of the school site for \$212,500 an acre was conditioned upon the City of Ontario purchasing an adjacent 7.1 acres for use as the school playground. In addition, the purchase was conditioned upon the developer paying the District's special tax on each home built in the development regardless of the ultimate decision of the State Supreme Court on this issue. These two conditions had the effect of lowering the cost of the property to less than \$150,000 per acre.

Again, on behalf of the Chino Unified School District, I want to thank the Office of the Auditor General for its diligence and its professionalism in conducting this audit.

Sincerely,



Stephen A. Goldstone, Ed.D.
Superintendent

*The Office of the Auditor General's comment: We do not agree with the conclusions reached by the district's independent auditor in their 1991 audit report regarding implementation of the nine recommendations from their 1990 report. As we state on page 19 of the report, "although the district has taken some steps toward implementing two of the three recommendations, it has not fully implemented any of them."

cc: **Members of the Legislature**
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps